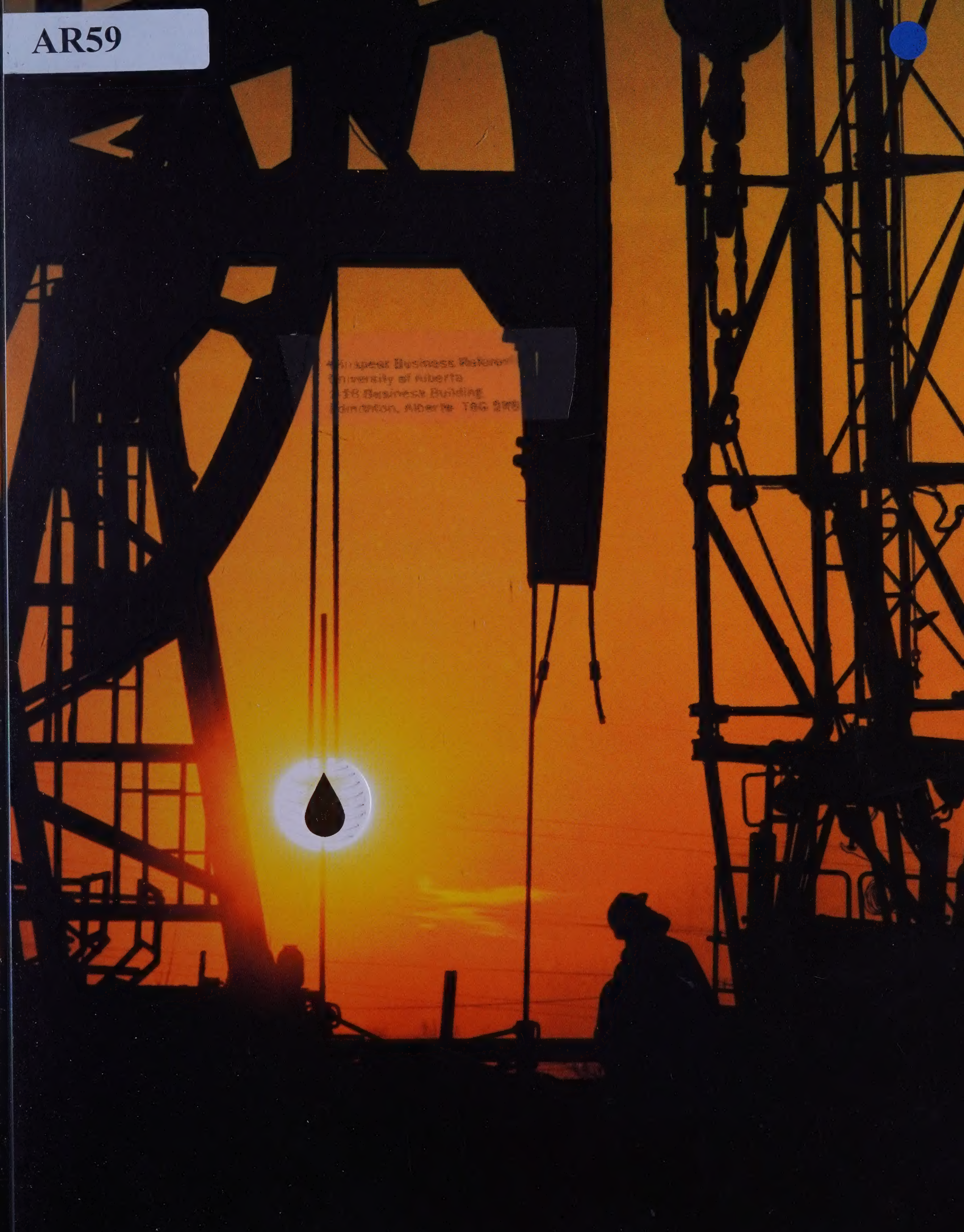

1997 ANNUAL REPORT

CanBaikal RESOURCES INC.

КанБайкал РЕЗОРСЕЗ ИНК

Corporate Profile

Production Operations Well #10 Kulun North

CanBaikal Resources Inc. is a Canadian based oil and gas company operating in Russia. Its mission is to create wealth for shareholders by acquiring and producing large scale reserves of oil and gas in the prolific western Siberian basin in Russia.

CanBaikal's strengths lie in our close relationship with the major players in the Russian oil and gas industry and the government bodies which administer to it. We will use these strengths to both accelerate our entry into the production of our existing reserves as well as to add to our reserve base through tenders and commercial acquisitions.

CanBaikal combines extensive senior management experience in the Russian oil and gas sector with Siberia's known enormous and relatively untapped reserves and an increasingly favourable operating environment. This unusual combination offers CanBaikal's investors a ground floor opportunity to participate in the emerging Russian oil and gas industry. CanBaikal's common stock trades on The Alberta Stock Exchange under the symbol "CBQ".

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IBC Corporate Information

Annual Meeting

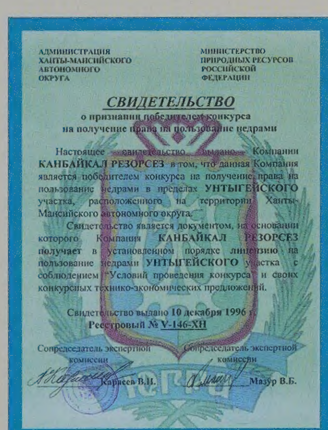
The Annual Meeting of the Shareholders of CanBaikal Resources Inc will be held at 3:00 p.m. on June 17, 1998 in the McMurray Room of the Calgary Petroleum Club, 319 - 5th Ave. S.W., Calgary, Alberta.

Chairman's Message to Shareholders

CanBaikal Milestones

- **Won bid in Tender V land sale on Block 146 in late 1996**
- **Awarded license on Block 146 on February 4, 1997, the first ever awarded by Khanty Mansiysk government to a foreign company**
- **Completed an initial public offering in July 1997, raising $5 million**
- **Opened an office in Nefteyugansk and commenced Russian operations in October 1997**
- **Expanded cooperation agreement with Yuksi**
- **Placed first Russian well on production on February 28, 1998 at an average rate of 750 barrels per day**
- **Participated in the Tender VI land sale on April 14, 1998**

CanBaikal Resources Inc.'s first full year of operations was marked by many milestones as the Company continued its strategy to add significant shareholder value through the Russian land tender process and through associations with Russian companies. We are confident that our strategy will be successful as we balance exploration and political risk, using our extensive expertise and understanding of the administrative and operational systems in the Khanty Mansiysk province of Russia.



АДМИНИСТРАЦИЯ ХАНТЫ-МАНСИЙСКОГО АВТОНОМНОГО ОКРУГА

МИНИСТЕРСТВО ПРИРОДНЫХ РЕСУРСОВ РОССИЙСКОЙ ФЕДЕРАЦИИ

СВИДЕТЕЛЬСТВО

о признании победителем конкурса на получение права на пользование недрами

Настоящее свидетельство выдано Компании **КАНБАЙКАЛ РЕЗОРСЕЗ** в том, что данная Компания является победителем конкурса на получение права на пользование недрами в пределах **УНТЫГЕЙСКОГО** участка, расположенного на территории Ханты-Мансийского автономного округа.

Свидетельство является документом, на основании которого Компания **КАНБАЙКАЛ РЕЗОРСЕЗ** получает в установленном порядке лицензию на пользование недрами **УНТЫГЕЙСКОГО** участка с соблюдением "Условий проведения конкурса" и своих конкурсных технико-экономических предложений.

Свидетельство выдано 10 декабря 1996 г.
Реестровый № V-146-ХН

Сопредседатель экспертной комиссии Карасев В.И.

Сопредседатель экспертной комиссии Мазур В.Б.

Tender certificate and operating license

In late 1996 your Company was successful in its first bidding attempt to acquire acreage in Russia. CanBaikal became the first western company to have the right to negotiate an oil and gas license from the provincial government in Khanty Mansiysk. We negotiated throughout the December - January period and on February 4, 1997 our license was granted. This license allows us to produce and develop our field completely independently if we so choose. In November, your Company was registered as a Foreign Legal Entity in Russia, a status which grants us many of the rights and privileges of a Russian oil company. The successful completion of the license and registration are very important to CanBaikal as they give us the flexibility and freedom to run our operations in the most efficient and economical manner.

In the summer of 1997, CanBaikal raised $5 million in its initial public offering. The Company was listed on the Alberta Stock Exchange under the symbol CBQ on August 1, 1997. These initial funds were critical for the Company as they allowed us to further evaluate our existing property and to continue to evaluate other prospects as we became aware of them.

In December of 1997, after receiving all the necessary statutory approvals, your Company built a winter access road to one of the existing exploratory wells on our block. We then proceeded to fracture and

Russian drilling rig

recomplete the well in order to test the well and put it on an extended production test. The well performed better than we had expected and provided us with more assurance that our reserve estimates of up to 100 million barrels of oil on the block are realistic and achievable.

1997 has been a successful year for CanBaikal and all of our objectives have been met. There have been obstacles to overcome but your Company has managed to solve any problems we encountered and we are well on our way to our long term goal of being a significant independent oil and gas exploration and production company in Russia.

The upcoming year will be a busy and important one for our young Company. In keeping with our strategy to expand our reserve base we will continue to participate in upcoming tenders in the Khanty Mansiysk region. We were outbid in Tender VI on April 14, 1998 but remained the only independent western company to participate and we expect to participate in two more tenders in the fall of 1998.

We also intend to expand upon our ongoing relationship with Yuksi, the largest oil company in Russia. We have entered into an umbrella agreement covering marketing and joint development of Yuksi lands which will be advantageous to CanBaikal.

Finance issues will play a major role in the coming year for CanBaikal. We have engaged J.P. Morgan to advise us on the financial markets and assist us in raising the capital that we require to continue adding to our reserve base and to develop our existing reserves. Due to the recent fall in oil prices the markets for oil and gas issues have dramatically fallen. Your Company, with the assistance of J.P. Morgan, will monitor these markets and attempt to select the most opportune time to raise additional capital.

I would like to take this opportunity to welcome our new Russian employees to the CanBaikal team and to thank all of our employees, the Board of Directors and our shareholders for their continuing support. We are confident that our strategies will result in significant added value for our shareholders.

R. J. Bolton

Robert J. Bolton
Chairman and C.E.O.
May 5, 1998

Western Siberian Basin and location of CanBaikal License Block 146V

Russian Field Operations

On February 4, 1997 CanBaikal was issued a license by the Russian government and the Province of Khanty Mansiysk to explore, develop and produce License Block 146, "the Untygey Block". Khanty Mansiysk is the principal producing oil province of Russia, accounting for approximately 70% of the total national oil production. The license issued to CanBaikal was the first ever issued to an international company and was a clear statement by the Khanty Mansiysk Government of its desire for participation and investment in western Siberia by international oil companies.

Upon the granting of the licence, the Company proceeded to establish operations in Russia and registered as a Permanent Representative Office, "PRO", in the Province of Khanty Mansiysk. The head office was established in the city of Nefteyugansk (population 100,000), located 50 km south west of the large oil city of Surgut and 100 km north west of the Company's operations on the Untygey Block. The office was opened in October and currently employs a small technical and administrative staff.

The Untygey Block is situated in the south central region of the western Siberian oil basin and currently has four oil pools identified within the Block. The surface terrain on the Block is primarily swamp and, until infrastructure is constructed, access to and within the Block is possible only in the winter months of November to April. Given this physical setting the Company's 1997/98 winter program focused on evaluation of the reservoir by well testing and reprocessing of existing seismic. The results of this evaluation will serve as the basis for planning the forthcoming 1998/99 drilling and development program.

Work began in mid-December with construction of a winter road from the Well #10 wellsite to the main east-west all weather road leading to the West Ugut Pump Station. The well servicing company of UganskFracmaster moved onto the well site to complete and test the well. The well went on production February 28 and the oil was trucked to the nearby pump station for ultimate delivery to the national pipeline system.

During the one month production period Well #10 was thoroughly tested and demonstrated good

Trucking oil from Well #10

reservoir characteristics and productivity. Average production during the period was 750 barrels of oil per day. Oil trucking and delivery to the pipeline was terminated at the end of March due to spring break up of the Company's temporary winter road.

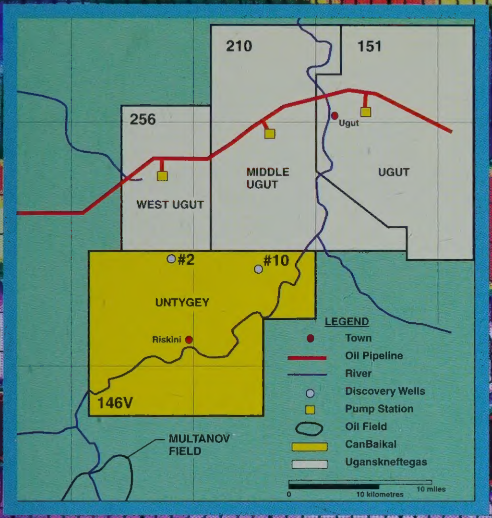
In addition to reservoir evaluation work, the Company's other primary objective during the period was to develop a comprehensive exploration plan for the Block. To date approximately 600 km of existing seismic data have been acquired, processed and interpreted. This work was completed between October 1997 and April 1998 and yielded encouraging results, both in terms of new prospective anomalies and possible expanded reserves for existing pools.

Planned Exploration and Development Activity - Winter 1998/99

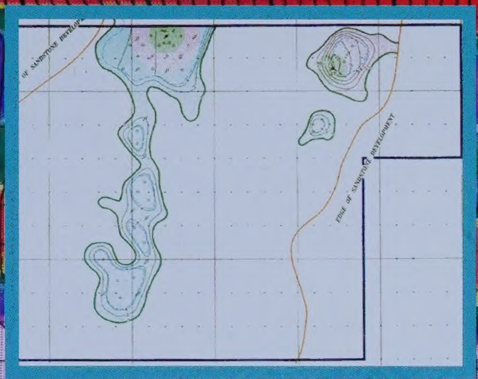
The Company is planning an active development drilling program on the Untygey Block starting in November 1998. In addition, new exploratory work is also planned, both to test new targets and to fulfill contractual commitments under the license for the Block.

The development program will be to bring reserves from the Kulun North pool on production as quickly as possible through construction of infrastructure and drilling pads in the early winter season, followed by a drilling program starting in the first quarter of 1999. A pipeline system connecting the Kulun Field to the West Ugut Pump Station will also be constructed, as will all necessary oil and gas production facilities. With the proper infrastructure in place, each new producing well will be tied-in and placed on production as it is completed.

In addition to development drilling, the Company plans to drill between one and three exploration wells during the 1998/99 winter season. The final location of these wells is currently being determined and is based on the Company's most recent interpretation of existing seismic data. The Company also plans to shoot a seismic program over the unexplored southern region of the Block.



Block 146 and adjacent oilfields



Proven and Probable Reserves U_1^2

Oil Reserves

The Company's oil reserves were evaluated, as at January 1, 1998, by the independent engineering firm of Gilbert Laustsen Jung and are summarized as follows:

	Proved	Proved plus Probable
Marketable Oil Reserves (000's barrels)		
Gross	5,253	17,798
Company Interest	5,085	16,424
Net after Royalty	5,083	15,905
Present Value of Estimated Future Net Cash Flow After Tax (million $)		
Undiscounted	17.1	106.7
@10.0%	4.1	58.4
@15.0%	0.0	43.8

The above reserves and values are based on an estimated 1998 Siberian wellhead oil price of US$13.50 per bbl, which assumes 25% of the production will be sold on the export market (assuming $17.50 U.S. Brent) and the balance to the Russian domestic market.

Unless otherwise noted, all values are presented in Canadian dollars assuming a US dollar to Canadian dollar conversion rate of 1.40. Although the Company produces natural gas in association with oil, the gas volumes are small and will be consumed locally in the treating operations.

Hydraulic fracturing

Corporate Operations

In order to manage its operations, CanBaikal has started the process of building an experienced management team, both in Calgary and Nefteyugansk. Entering 1997, the management team included Robert Bolton - Chairman and Chief Executive Officer, Robert Niven - President and Chief Operating Officer and Alexander Borissov - Vice President, Business Development. John McGruther joined the Company as Controller in mid year 1997 and has worked extensively in Russia for the past 6 years.

With CanBaikal moving into full operational mode in Russia, we were pleased to announce that in February Dale Miller had joined the Company as Chief Financial Officer. Mr. Miller has over 20 years experience in the oil and gas industry.

The Company's operational staff in Nefteyugansk is headed by Ralph Crownover and plans are underway during the summer of 1998 to build the technical and administrative strengths of this office in preparation for the winter development program. The emphasis will be on staffing this office with Russian professionals using western management supervision and practices.

Management's Discussion and Analysis

1997 has been a very busy and successful year for CanBaikal Resources Inc. The Company has completed its initial public offering for $5 million and has established its base of operations in Russia. CanBaikal holds a 100% interest in a 400 square kilometer block in western Siberia and intends to fully develop the block in the next 24 months. Gilbert Laustsen Jung Associates have assigned proven reserves of over 5 million barrels of oil and probable reserves in excess of 11 million barrels of oil to an area surrounding the two exploration wells in the northern end of the block. Russian estimates of reserves on the whole block total 141 million barrels and Company estimates for the license approach 100 million barrels. This block is a major asset and will require capital expenditures in excess of $70 million to develop the reserves reported in the Gilbert Laustsen report.

Revenues

In 1997, the Company was in a preproduction stage of its development and the only revenue generated by the Company was interest revenue, amounting to $62,070. The Company hopes to establish significant production from its block in late 1998 or early 1999.

Expenses

The majority of the Company's expenses in 1997 related to the opening and running of our offices in Calgary and in Nefteyugansk. A total of $486,650 was expensed in 1997 with another $300,657 capitalized to petroleum and natural gas properties as being directly related to exploration and development activities. Salaries and wages totaled $90,553 and consulting and professional fees totaled $154,390. Office expenses including rent, telephone and travel totaled $151,952. All expenses incurred by the Company relate to the further evaluation of Block 146 or the ongoing evaluations of tenders and other business opportunities in Russia.

Capital Expenditures

CanBaikal incurred capital expenditures of $1,455,495 in 1997. Of this total, $109,204 was expended on computer hardware and software and other office equipment. A total of $1,346,291 was capitalized to petroleum and natural gas properties with over $300 thousand of these expenditures being capitalized overhead. The Company has incurred in excess of $300 thousand on seismic purchases and reprocessing.

Evaluation costs on the Tender VI bid totaled approximately $300,000 and the costs for the development plan for Block 146 totaled approximately $200 ,000. All of these costs include the cost of travel and consultants and are one time costs.

Capital Resources and Liquidity

In 1997, the Company raised $5 million through a public issue and subsequently received almost $700,000 related to the conversion of warrants, which were attached to the original issue. Share issue costs related to these issues totaled approximately $600,000. CanBaikal's working capital position at year-end was in excess of $3.4 million and provides the Company with the necessary capital to continue its efforts to add reserves through the Russian tender process. However, this is not enough capital to develop our current reserves and the Company has plans to raise the required capital through the issuance of shares in 1998.

The Company has entered into an agreement with J.P. Morgan to act as our financial advisor for a two-year period. The contract calls for J.P. Morgan to advise us on capital markets and assist us in developing our long-term financial plans as they relate to the development of our current asset and other growth opportunities. The worldwide depression of oil prices and equities caused a delay

in the planned J.P. Morgan offering in late March, 1998. At present, we are monitoring these markets and will raise the development capital we require at the appropriate time and at an appropriate price. The Company is also reviewing other financing options to assist us in adding value to the Company through a small program of step out drilling on Block 146.

Net Asset Value per Share

CanBaikal's net asset value at December 31, 1997 was $2.54 per share based on the Gilbert Laustsen reserve report effective December 31, 1997. As stated previously, this report evaluates only a small portion of our existing land holdings and the potential upside of further reserves existing on the block is substantial.

	(000's)
Reserve Value,	
Proved &1/2 Probable	
@ 10% After Tax	$ 31,250
Working Capital	
@ December 31, 1997	3,453
Undeveloped Land	1,000
Total Assets	$ 35,703
Basic Shares Outstanding	14,048
Fully Diluted	17,767
Basic Asset Value per Share	$ 2.54
Fully Diluted per Share	$ 2.01

Business Risk

The Company's operations are currently based entirely in Russia. The political situation, income tax legislation, banking regulations and general operating environment are changing continuously as Russia makes the transition from a command to a market oriented economy. The Company's operations and financial position will continue to be affected by Russian political developments, including the application and interpretation of existing and future legislation and regulations pertaining to production, imports, exports, oil and natural gas and income tax. Management is continuously monitoring potential developments and changes as they occur. The senior management team at CanBaikal is confident that the political and economic environment in Russia today is viable for economic operations and will only improve over time.

Outlook

CanBaikal has established itself as an operating company in Russia with clear ownership of a valuable asset which is ready for exploitation. The timing of this development is dependent on world oil prices and the response of capital markets. The Company is reviewing all possibilities of raising the required funds in 1998. However, the exact timing of the financing and subsequent development remains unknown.

The Company will generate significant production and cash flow within a short period after the financing is completed. Currently we are evaluating a smaller private placement which, while minimizing dilution, will allow the Company to continue its drilling program and reserve acquisition program. We will continue to add shareholder value by meeting our planned objectives within the constraints imposed by the financial markets. The legislative and taxation environment for our Company in Russia has improved and we expect this to continue throughout 1998.

Management's Report

The consolidated financial statements are the responsibility of the management of CanBaikal Resources Inc. They have been prepared in accordance with generally accepted accounting principles, using management's best estimates and judgements, where appropriate.

Management is responsible for the reliability and integrity of the consolidated financial statements, the notes to the consolidated financial statements, and other financial information contained in this report. In the preparation of these statements, estimates are sometimes necessary because a precise determination of certain assets and liabilities is dependent on future events. Management believes such estimates have been based on careful judgements and have been properly reflected in the accompanying consolidated financial statements.

Management is also responsible for maintaining a system of internal control designed to provide reasonable assurance that assets are safeguarded and that accounting systems provide timely, accurate and reliable financial information.

The Board of Directors is responsible for ensuring that management fulfills its responsibilities for financial reporting and internal control. The Board is assisted in exercising its responsibilities through the Audit Committee of the Board, which includes three non-management Directors. The Audit Committee meets periodically with management and the auditors to satisfy itself that management has met its responsibilites and the Board of Directors have approved the consolidated financial statements on the recommendation of the audit committee.

Doane Raymond, the independent auditors appointed by the shareholders, have audited the Company's consolidated financial statements in accordance with generally accepted auditing standards and their report follows. The independent auditors have full and unrestricted access to the audit committee to discuss their audit and their related findings as to the integrity of the financial reporting process.

R. J. Bolton

Robert J. Bolton
Chairman and Chief Executive Officer
May 8, 1998

Dale Miller

Dale Miller
Chief Financial Officer

Auditors' Report

To the Shareholders of
CanBaikal Resources Inc.

We have audited the consolidated balance sheets of CanBaikal Resources Inc. as at December 31, 1997 and 1996 and the consolidated statements of operations and deficit and changes in financial position for each of the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1997 and 1996 and the results of its operations and changes in its financial position for each of the years then ended in accordance with generally accepted accounting principles.

Doane Raymond

Doane Raymond
Chartered Accountants

Calgary, Alberta
January 16, 1998

Consolidated Balance Sheet

December 31	1997	1996
Assets		
Current		
Cash and term deposits	$ 3,462,804	$ 844,840
Receivables	74,650	1,735
	3,537,454	846,575
Deferred financing charges (Note 4)	205,732	–
Fixed (Note 5)	105,767	15,446
Petroleum and natural gas properties (Note 6)	2,568,259	1,221,968
	$ 6,417,212	$ 2,083,989
Liabilities		
Current		
Payables and accruals	$ 84,303	$ 425,660
Shareholders' Equity		
Capital stock (Note 7)	6,810,586	1,711,426
Deficit	(477,677)	(53,097)
	6,332,909	1,658,329
	$ 6,417,212	$ 2,083,989

On behalf of the Board

R. J. Bolt

Director

Director

See accompanying notes to the consolidated financial statements.

Consolidated Statement of Operations and Deficit

Year ended December 31	1997	1996
Revenue		
Interest income	$ 62,070	$ –
Expenses		
Advertising and promotion	18,594	1,548
Bank charges	10,060	114
Consulting fees	70,000	–
Depreciation	18,883	1,026
Insurance	42,218	–
Office	151,952	13,748
Professional fees	84,390	36,661
Wages and benefits	90,553	–
	486,650	53,097
Net loss	(424,580)	(53,097)
Deficit, beginning of year	(53,097)	–
Deficit, end of year	$ (477,677)	$ (53,097)
Loss per Common Share	$ (0.038)	$ (0.014)
Weighted average number of shares outstanding	11,223,432	3,792,642

See accompanying notes to the consolidated financial statements.

Consolidated Statement of Changes in Financial Position

Year ended December 31	1997	1996
Cash derived from (applied to)		
Operating		
Net loss	$ (424,580)	$ (53,097)
Depreciation	18,883	1,026
	(405,697)	(52,071)
Change in non-cash working capital items (Note 8)	(414,272)	423,925
	(819,969)	371,854
Financing		
Deferred financing charges incurred	(205,732)	–
Issue of shares for cash	5,697,693	1,324,426
Issue of shares on purchase of subsidiary	–	387,000
Share issue costs	(598,533)	–
	4,893,428	1,711,426
Investing		
Additions to petroleum and natural gas properties	(1,346,291)	(981,114)
Acquisition of fixed assets	(109,204)	(16,472)
Acquisition of subsidiary, net of cash of $146,146	–	(240,854)
	(1,455,495)	(1,238,440)
Net change in cash and term deposits	2,617,964	844,840
Cash and term deposits, beginning of year	844,840	–
Cash and term deposits, end of year	$ 3,462,804	$ 844,840

See accompanying notes to the consolidated financial statements.

December 31, 1997

1. Nature of operations

The Company was incorporated August 14, 1996 and is engaged primarily in the exploration for and development of petroleum and natural gas in the former Soviet Union. Since inception, the efforts of the Company have been devoted to the acquisition of exploration and production licenses and the development thereof. To date, the Company has not received revenue from these operations and is considered to be in the development stage.

The costs associated with the acquisition of the licenses and development thereon to December 31, 1997 are recognized in these consolidated financial statements in accordance with the accounting policies outlined in Note 2. Accordingly, their carrying value represents costs incurred to date and do not necessarily reflect present or future values. The recoverability of these amounts is dependent upon the existence of economically recoverable petroleum and natural gas reserves, the ability of the Company to obtain necessary financing to complete their development and upon future profitable operations.

2. Summary of significant accounting policies

Principles of consolidation

These consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, PolarQuest Petroleum Corporation.

Measurement uncertainty and the use of estimates

The preparation of the consolidated financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. These estimates are subject to measurement uncertainty. Actual results could differ from and affect the results reported in these consolidated financial statements.

Depreciation

Depreciation of fixed assets is computed using the declining balance method at the rates indicated in Note 5. In the year of acquisition only one-half of the normal depreciation is recorded.

Petroleum and natural gas properties and depletion

The Company follows the full cost method of accounting for its petroleum and natural gas operations. Under this method all costs related to the exploration for and development of petroleum and natural gas reserves are capitalized. Costs include lease acquisition costs, geological and geophysical expenses, overhead directly related to acquisition, exploration and development activities and costs of drilling both productive and non-productive wells. Proceeds from the sale of properties are applied against capitalized costs, without any gain or loss being realized, unless such sale would significantly alter the rate of depletion and depreciation.

Upon determination of estimated proven petroleum and natural gas reserves and the commencement of economic production quantities, depletion will be provided using the unit of production method.

In applying the full cost method, the Company calculates a ceiling test whereby the carrying value of petroleum and natural gas properties and production equipment, net of recorded deferred income taxes and the accumulated provision for site restoration and abandonment costs, is compared annually to an estimate of future net cash flows from the production of proven reserves. Net cash flow is estimated using year end prices, less estimated future general and administrative expenses, financing costs and income taxes. Should this comparison indicate an excess carrying value, the excess is to be charged against earnings as additional depletion and depreciation.

Financial instruments

The Company has estimated the fair value of its financial instruments which include cash and term deposits, receivables and payables and accruals. The Company has used valuation methodologies and market information available as at year end and has determined that the carrying amounts of such financial instruments approximate fair value in all cases.

Future site restoration and abandonment costs

Estimated future costs relating to site restoration and abandonments will be provided for over the life of proven reserves on a unit of production basis.

Costs will be estimated, net of expected recoveries, based upon Russian legislation, costs, technology and industry standards. The annual provision will be recorded as additional depletion.

Foreign currency translation

Accounts denominated in foreign currency are translated into Canadian dollars using the year end rate of exchange for monetary assets and liabilities and the rate of exchange in place on the transaction date for non-monetary assets and liabilities and revenues and expenses. Foreign currency gains and losses are charged to earnings.

3. Business combination

Effective November 29, 1996 pursuant to a share exchange agreement, CanBaikal Resources Inc. ("CanBaikal") acquired all of the issued and outstanding shares of PolarQuest Petroleum Corporation ("PolarQuest"). As consideration CanBaikal issued 3,740,000 common shares for the 2,150,000 issued and outstanding shares of PolarQuest. As a result, the former shareholders of PolarQuest hold 55% of the voting shares of the combined entity.

This transaction is referred to as a reverse takeover and, for accounting purposes, PolarQuest is deemed to have acquired CanBaikal. The deemed acquisition of CanBaikal was accounted for by the purchase method and the fair value of the net assets acquired were:

Petroleum natural gas properties	$ 159,848
Increase to fair value	207,000
	366,848
Working capital, excluding cash	174,006
Other liabilities	(300,000)
	240,854
Cash	146,146
	$ 387,000

The value relating to share capital includes the share capital of PolarQuest together with the cost of the purchase as determined above. The number of shares issued and outstanding includes the number of CanBaikal shares issued and outstanding including the number of shares issued to effect the reverse takeover.

4. Deferred financing charges

Deferred financing charges relate primarily to costs associated with a financial advisory agreement with J. P. Morgan Securities Ltd. J. P. Morgan was appointed for a two year term as the Company's exclusive financial agent to assist in the raising of equity and/or debt financing on an ongoing basis.

If a financial offering is successful these costs will be allocated to the cost of issue. If a financial offering is not successful the costs will be expensed.

5. Fixed

	Rate	Cost	Accumulated Depreciation	**1997** Net Book Value	1996 Net Book Value
Computer hardware	30%	$ 48,179	$ 10,233	$ 37,946	$ 14,928
Computer software	100%	2,046	1,343	703	518
Office equipment	20%	59,713	5,971	53,742	–
Vehicle	30%	15,736	2,360	13,376	–
		$ 125,674	$ 19,907	$ 105,767	$ 15,446

6. Petroleum and natural gas properties

	1997	1996
Capitalized costs	$ 2,568,259	$ 1,221,968

During the year, $300,657 ($106,180 in 1996) of overhead expenses directly related to exploration and development activities were capitalized.

Total anticipated costs for site restoration and abandonment for the Russian properties as at December 31, 1997 are approximately $300,000.

7. Capital stock

Authorized:

Unlimited common shares, without par value

Unlimited preferred shares, issuable in series

Issued and outstanding common shares:

	1997		1996	
	Number	Amount	Number	Amount
Balance, beginning of year	8,502,849	$ 1,711,426	–	$ –
Initial private placement	–	–	3,060,000	473,000
Issued an acquisition of subsidiary	–	–	3,740,000	387,000
Rights offering exercised	–	–	1,202,849	601,426
Private placement issued	–	–	500,000	250,000
Initial public offering net of issue costs of $598,533	5,000,000	4,401,467	–	–
Rights offering exercised	14,000	7,000	–	–
Warrants exercised for cash	531,302	690,693	–	–
Total issued during the year	5,545,302	5,099,160	8,502,849	1,711,426
Balance, end of year	14,048,151	$ 6,810,586	8,502,849	$ 1,711,426

During the year ended December 31, 1996, stock options were granted to Directors of the Company. The options are for 840,000 common shares at a price of $1.00 per share and the options expire on December 18, 2001. A total of 840,000 common shares have been reserved for these options. All options granted are vested.

Pursuant to the initial public offering on June 16, 1997, the Company issued 5,000,000 units for a total consideration of $5,000,000 and net proceeds of $4,600,000 after agent's commission. Each unit consisted of one common share and 0.5 common share purchase warrant. A full warrant entitles the holder to acquire one common share of the Company at prices ranging from $1.30 to $1.60 expiring June 30, 1998. In conjunction with the initial public offering 500,000 share purchase warrants were issued to the Agent. Each warrant entitles the Agent to acquire one common share of the Company at a price of $1.00 per share. These warrants expire on January 10, 1999.

On June 24, 1997, the Company adopted a stock option plan available to officers, directors, employees of the Company and to key consultants and contractors. The options are exercisable up to five years from the date of granting. On July 21, 1997, the Company granted stock options to directors and key employees. The options are for 410,000 common shares at a price of $1.31 per share. A total of 410,000 common shares have been reserved for these options. These options expire on July 21, 2002.

During the year, the Company issued 531,302 common shares for a total cash consideration of $690,693 upon certain common share purchase warrants being exercised. At December 31, 1997, 1,968,698 common share purchase warrants are outstanding.

8. Change in non-cash working capital items

	1997	1996
Receivables	$ (72,915)	$ (1,735)
Payables and accruals	(341,357)	425,660
	$ (414,272)	$ 423,925

9. Related party transactions

a) Corporations in which certain of the Company's officers or directors are shareholders have provided services at fair market value, as outlined below:

	1997	1996
Geological and exploration	$ 88,879	$ 61,100
Office rent	$ 21,168	$ 6,847
Consulting fees	$ 30,000	$ 6,300

b) During the year, office equipment totalling $19,210 was acquired from a company controlled by an officer and director. Consideration given was an amount agreed to by the related parties which approximated fair market value.

c) Included in payables and accruals is $Nil ($61,242 in 1996) due to companies related by virtue of common management or directors.

10. Income taxes

a) The Company and its subsidiary are required to file tax returns in each of the jurisdictions in which they operate. The prime operating jurisdictions are Canada and Russia.

The Company has incurred losses for Canadian income tax purposes of approximately $597,670, the related benefit of which has not been recognized in the consolidated financial statements. Unless sufficient taxable income is earned these losses will expire as follows:

2003	$ 31,359
2004	$ 566,311
	$ 597,670

b) At December 31, 1997, the Company has available the following amounts which may be deducted, at the annual rates indicated, in determining taxable income for Canadian income tax purposes of future years:

Undepreciated capital costs	30% to 100%	$ 125,675
Foreign exploration and development expense	10%	$ 2,354,468
Cumulative eligible capital	7%	$ 15,541
Share issue costs	20%	$ 643,412

11. Commitments and contingencies

a) Within the first five years of the term of the exploration and production license, the Company must achieve certain targets for seismic exploration and evaluation and must drill at least four wells by the end of 2000. Under the license, the taxes and payments required to be paid by the Company include: 1% of estimated exploration evaluation costs; 3% of the estimated exploration costs for delineation wells; 7% of the value of production; and other taxes stipulated by the authorities.

b) The Company's petroleum and natural gas operations are currently based entirely in Russia. The political situation, income tax legislation, banking regulations and the general operating environment are changing continuously as Russia makes the transition from a command to a market orientated economy. The Company's operations and financial position will continue to be affected by Russian political developments including the application and interpretation of existing and future legislation and regulations pertaining to production, imports, exports, oil and natural gas and income tax. It is possible that these developments may have a significant impact on the Company's ability to continue operations. The likelihood of such developments is not determinable. Management is continuously monitoring potential developments and changes as they occur.

12. Segmented information

The Company's oil and natural gas exploration and development activities are conducted in Canada and Russia. The following information relates to the Company's geographic segments by country:

	1997		1996	
	Canada	Russia	Canada	Russia
Net loss for the year	$ (375,188)	$ (49,392)	$ (53,097)	$ –
Identifiable assets	$ 3,613,150	$ 2,804,062	$ 862,021	$ 1,221,968

13. Loss per share

Loss per share has been calculated using the weighted average number of shares outstanding for the year. Outstanding stock options and warrants have no dilutive effect on loss per share.

14. Subsequent events

a) On January 16, 1998, the Company issued 3,750 common shares for a total cash consideration of $6,000 upon certain common share purchase warrants being exercised.

b) On January 30, 1998, the Company entered into a rental agreement for office premises. The office lease expires on February 28, 2003. The future estimated operating and rental costs are as follows:

1998	$ 200,155
1999	$ 200,155
2000	$ 200,155
2001	$ 200,155
2002	$ 200,155

15. Comparative figures

Certain of the 1996 comparative figures have been reclassified in order to conform to the presentation adopted in the current year. Comparative figures for the statements of operations and deficit and changes in financial position are for the four month period from incorporation to December 31, 1996.

Corporate Information

Corporate Management

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President and C.O.O.

Dale R. Miller
Vice-President and C.F.O.

Alexander A. Borissov
Vice-President, Business Development

John W. McGruther
Controller

Robert James
Corporate Secretary

Directors

Daryl E. Birnie
Director

Robert J. Bolton
Chairman and C.E.O.

Fred C. Coles
Director

Kevin Flaherty
Director

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Registrar & Transfer Agent

Montreal Trust
Calgary, Alberta

Listing

The Alberta Stock Exchange
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